Semi-Annual Report
Kentucky Asset/Liability Commission

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For the period ending December 31, 2006

This report may be viewed at

http://finance.ky.gov/ourcabinet/caboff/OOC/ofm/debt/AlcoSemiAnnualRpt.htm

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INTRODUCTION

This is the Kentucky Asset/Liability Commission's ("ALCo") twentieth semi-annual report pursuant to KRS 56.863 (11) for the period beginning July 1, 2006 through December 31, 2006. Several factors on both the state and national level had an impact on activity during the reporting period. The most significant factors were:

On the national level

- U. S. economy experiences slowdown in growth while consumption remains robust.
- War in the Middle East continues.
- The Dow Jones Industrial Average finishes the calendar year at 12,463 up 1,313 points from June 2006.
- Ben Bernanke completes first year as chairman of Federal Reserve.
- Fed funds rate remains unchanged after 17 quarter-point increases over the past two years.

On the state level

- Continued implementation of the two largest bond authorizations in the history of the Commonwealth.
- First half of fiscal year 2007 General Fund revenues increased 2.5 percent over the same period in fiscal year 2006.

INVESTMENT MANAGEMENT

Market Overview

At the August 8, 2006 Federal Open Market Committee ("FOMC") meeting, the string of 25 basis point increases in the federal funds rate came to an end. The fed funds rate is the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight. The FOMC had increased fed funds by 25 basis points at each meeting since May 2004. As would be expected, this string of tightenings had an impact on the overall economy and inflation. Growth in the overall economy, as measured by the quarterly change in Real Gross Domestic Product (GDP), fell from an average of 3.175 percent during calendar year 2005 to only 2.1 percent during the second half of the 2006 calendar year.

As measured by the headline Consumer Price Index ("CPI"), inflation has fallen from a high of 4.7 percent in September 2005 to 2.5 percent in December 2006. The core rate, which excludes volatile food and energy components, has fallen from a high of 2.9 percent in September 2006 to 2.6 percent in December 2006. Using the FOMC's favorite measure of inflation, the Core GDP Consumption Price Index shows inflation has fallen to 1.9 percent during the fourth quarter of 2006. These measures show inflation to be within, or at least approaching, the upper end of the FOMC's comfort zone. While they still recognize a risk of inflation rising, the magnitude of this risk has fallen.

Given where things are, what are the implications for the economy going forward? The FOMC, in its December 12, 2006 statement, said "inflation pressures seem likely to moderate over time …" but "… that some inflation risks remain." Part of those risks are "the high level of resource utilization." Resource utilization is FOMC code for the unemployment rate. According to the household survey, the unemployment rate has dropped to about 4.5 percent during the fourth quarter of 2006. Some economists argue that this low of a level of unemployment is inflationary because it is easy to find alternative employment and employees have an easier time negotiating salary increases which, if spread wide enough, exert upward pressure on inflation.

Another forward looking indicator is the shape of the yield curve. The yield curve is the relationship between the different maturities of Treasury securities and the corresponding yields on those securities. Generally, bonds with a longer term to maturity will have a higher yield. Currently, the yield curve is "inverted." For example, the 10-year Treasury has a lower yield than the 6 month Treasury Bill. In all but one recession since World War II, the yield curve inverted 6 to 18 months prior to the onset of the recession. (There have been several cases where the yield curve inverted but the economy did not fall into recession.) This indicator predicts continued softening in the economy.

One other factor affecting future growth prospects is the housing market. During the boom of the last several years, certain mortgage lenders extended credit to "sub-prime" borrowers. These are borrowers with weaker than average credit. The terms of the loans assumed that the borrower would be able to refinance as the value of the home increased along with the overall market. As mortgage rates have increased, the home appreciation rate has declined and actually turned negative in some markets. These sub-prime borrowers are no longer able to refinance since the values of the homes have not increased. The result is a rapid rise in sub-prime delinquencies. To date, thirty one sub-prime lenders have either left the market or entered bankruptcy. This experience is beginning to place a drag on the economy but the extent is difficult to estimate.

Portfolio Management

For the six months ending December 31, 2006, the Commonwealth's investment portfolio averaged $3.6 billion. As of December 31, 2006, the portfolio was invested in: U.S. Treasury Securities (7 percent), U.S. Agency Securities (25 percent), Mortgage Pass Through Securities (3 percent), Collateralized Mortgage Obligations (5 percent), Repurchase Agreements (20 percent), Municipal Securities (8 percent), Corporate Securities (7 percent), Asset-Backed Securities (8 percent) and Money Market Securities (17 percent). The portfolio had a market yield of 5.30 percent and an effective duration of .62 years.

The total portfolio is broken down into five investment pools. The pool balances as of December 31, 2006, were: Short Term Pool - $1,463 million, Intermediate Term Pool - $1,908 million, Bond Proceeds Pool - $198 million, TRAN Pool - $155 million, and UK Hospital Pool - $68 million.

Total investment income from all investments, on a cash basis, for the six months ended December 31, 2006, was $67.8 million versus $34.7 million for the six months ended December 31, 2005. On a full mark-to-market basis, investment income was $105.6 million for the six months ended December 31, 2006, versus $53.3 million for the same period in 2005.

The dramatic increase in earnings occurred for two reasons. First, interest rates were higher during 2006 than during 2005 lending to higher rates of return. Second, while less money was invested during the period, the distribution of the money was more heavily weighted to higher yielding pools.

Tax-exempt Interest Rates and Relationships

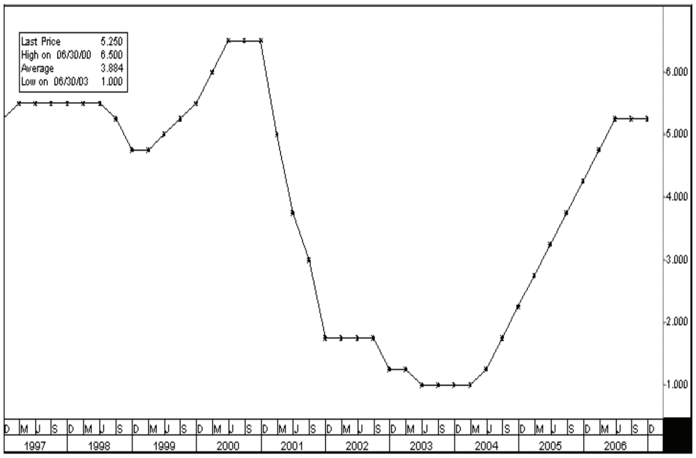
The Bond Buyer 20 year General Obligation Index averaged 4.40 percent for calendar year 2006. The high was 4.71 percent in June, the low was 4.03 percent in December and the year ended with 4.17 percent.

The Bond Market Association ("BMA") Municipal Swap Index averaged 3.45 percent for calendar year 2006. The low was 2.93 percent in January with a 3.97 percent high in June and ended the year at 3.91 percent. The 30-day USD London Interbank Offered Rate ("LIBOR") averaged 5.10 percent for the year. The low was 4.40 percent in January, the high was 5.42 percent in August, and the year ended at 5.32 percent. BMA traded as high as 75.4 percent of 30-day LIBOR in April and as low as 62.7 percent in May with an average of 67.6 percent for the year. The year ended with BMA as 73 percent of LIBOR.

Federal Funds Target Rate

FDTR INDEX

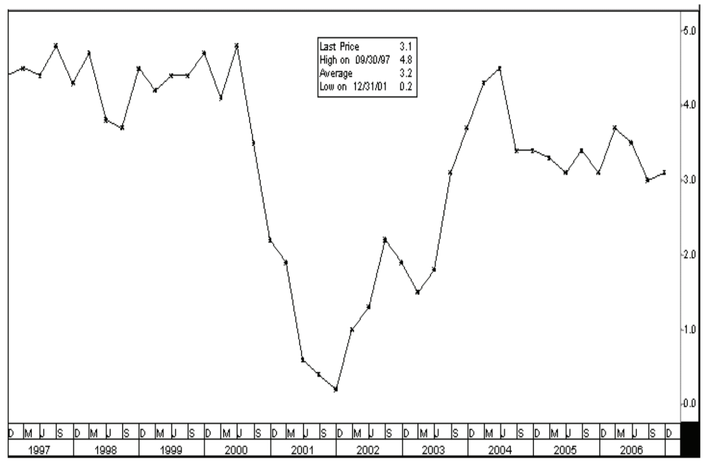
Range 12/31/96 – 12/29/06 Period Quarterly



Real Gross Domestic Product
YEAR-OVER-YEAR INDEX

GDP CYOY INDEX

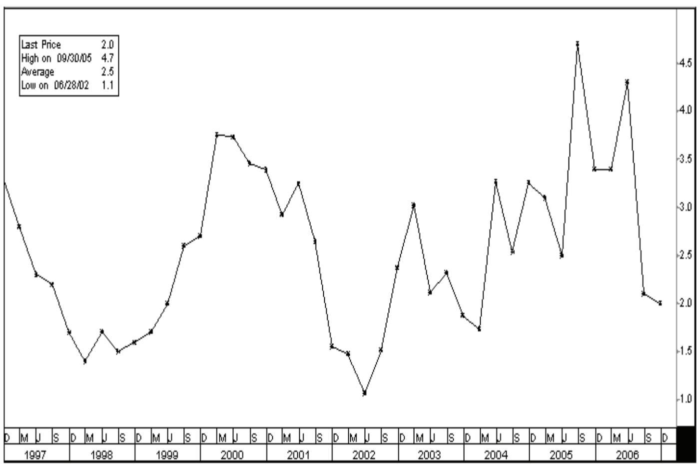
Range 12/31/96 – 12/31/06 Period Quarterly



Consumer Price Index
YEAR - OVER - YEAR INDEX

CPI YOY INDEX

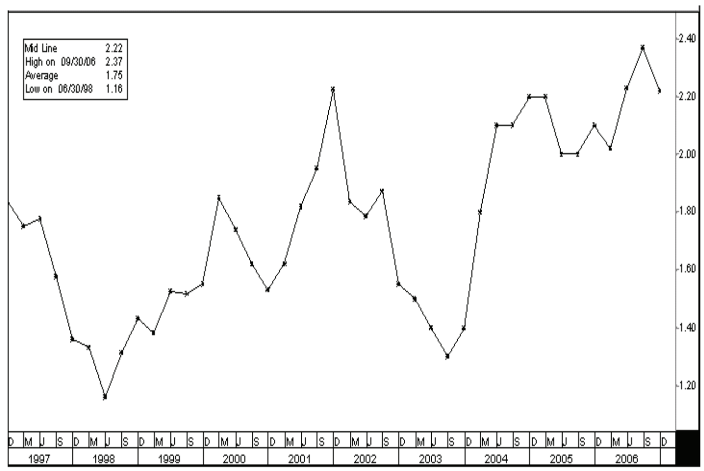
Range 12/31/96 – 12/29/06 Period Quarterly



US GDP Personal Consumption Core Price Index
YEAR- OVER- YEAR INDEX

GDPCPCEY INDEX

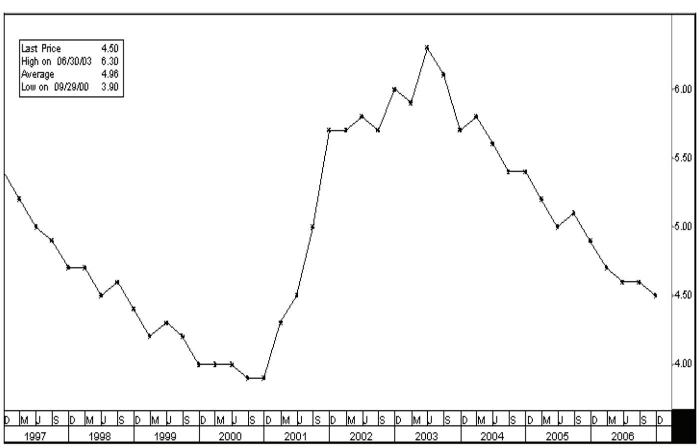
Range 12/31/96 – 12/31/06 Period Quarterly



Unemployment Rate

USURTOT INDEX

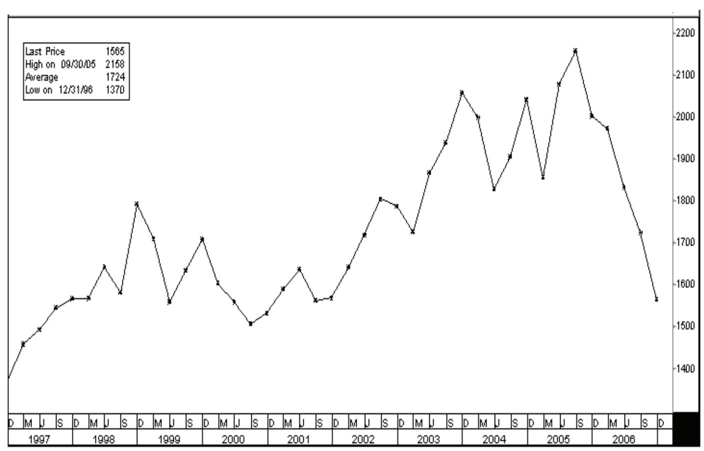
Range 12/31/96 – 12/29/06 Period Quarterly



Housing Starts

NHSPSTOT INDEX

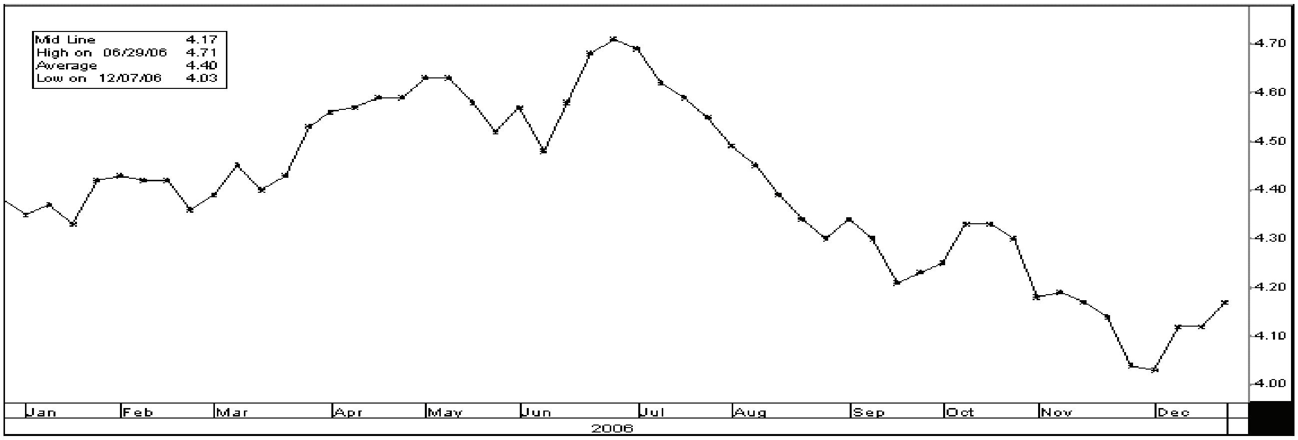
Range 12/31/96 – 12/29/06 Period Quarterly



Bond Buyer 20-year General Obligation Index

BBWK20GO INDEX

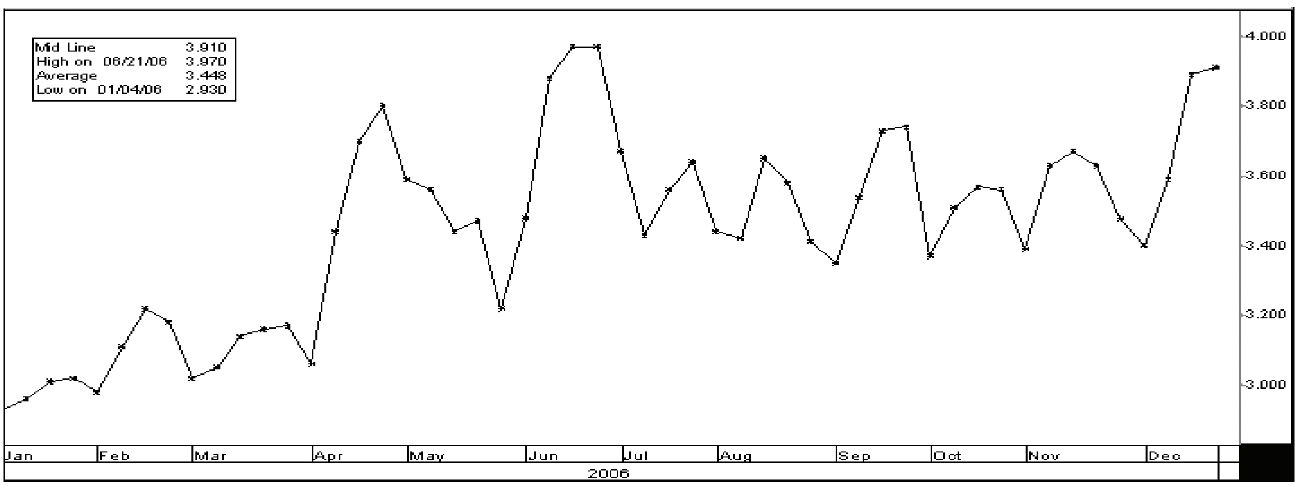
Range 12/29/05 12/28/06 Period Weekly



Bond Market Association "BMA"
Municipal Swap Index

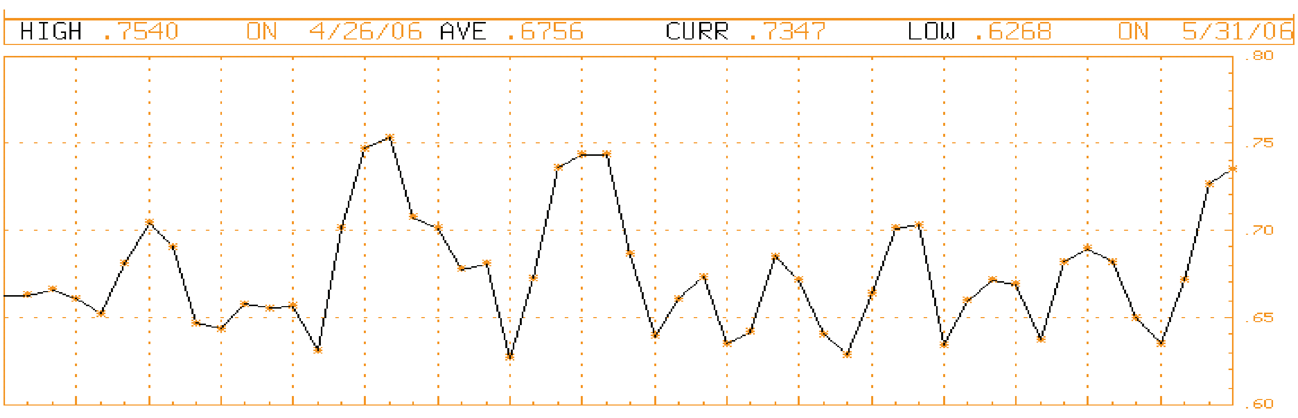
MUNIPSA INDEX

Range 01/04/06 – 12/27/06 Period Weekly



Bond Market Association "BMA" Municipal Swap Index
as a percent of one month LIBOR

RANGE 1/ 4/06 TO 12/27/06



DEBT MANAGEMENT

The 2005 Kentucky General Assembly enacted a State Budget for the biennium ending June 30, 2006, which authorized $2.056 billion of bond funded capital projects. The General Fund authorization was $1,204 million; the Road Fund authorization was $450 million; Agency Funds were authorized at $251.7 million; and $150 million was authorized to be supported by the Federal Highway Trust Funds. Bonds have been issued for the Road Fund and Federal Highway Trust Fund authorizations. Half of the Agency Fund and General Fund projects have been permanently funded by calendar year end 2006. Interim note financing is available for the remaining projects with $288 million scheduled for permanent bond financing by the State Property and Buildings Commission ("SPBC") and Universities in early 2007.

The 2006 General Assembly adopted a State Budget for the biennium ending June 30, 2008 which authorized an additional $2.3 billion of capital projects to be funded with debt. The General Fund authorization is $1,392.9 million; the Agency Fund authorizations total $267.5 million; while the Road Fund and Federal Highway Trust Fund authorizations are $350 million and $290 million, respectively. Twenty million has been scheduled for issuance but the timing of financing is uncertain for the bulk of the obligations and dependent on the expenditure needs.

Ratings Update

In September 2006, Standard & Poor's Ratings Service ("S&P") revised its special tax criteria for U.S. public finance issues, leading to a rating upgrade, to AA+ from AA, for the Kentucky Turnpike Authority's ("TAK") Economic Development Road Revenue Bonds (Revitalization Projects). S&P placed a greater emphasis on fundamental economic factors in the rating of bonds supported by highway user taxes (including gas taxes). S&P recognized the stability of fuel sales even during periods of high fuel prices and that other pledged revenues, such as motor vehicle registration fees and motor vehicle license fees, are derived from stable transportation related sources that cover a large statewide population base.

The rating agencies continually monitor the Commonwealth's performance in areas such as revenue, the economy and debt management. Early in calendar 2007, the rating agencies announced improvements in the state's rating outlook based on these ongoing reviews.

In January 2007, S&P revised its outlook, to positive from stable, on Kentucky's issuer credit rating and SPBC A+ rating. S&P stated its outlook revision reflected the state's positive economic and revenue growth, steadily replenishing reserves, and the expectation that the state will devise a long-term plan addressing rising pension and health care liabilities.

Moody's Investors Service ("Moody's") revised, to stable from negative, the outlook on the Commonwealth's issuer rating and appropriation debt with the Aa3 rating of SPBC 87 in February 2007. The revised outlook reflected a trend of state economic recovery and strengthened finances that have improved the Commonwealth's fiscal condition. Moody's expects that with a continuation of these trends, combined with the state's active financial management, Kentucky will maintain a strong fiscal condition resulting in an improved structural budget balance over the near-term.

Fitch Ratings ("Fitch"), in February 2007, joined the other firms' practice of assigning outlooks. Fitch views rating outlooks as an indication of the likelihood of a rating change over the next one to two years. Fitch assigned an initial rating outlook of stable to the SPBC lease obligations and affirmed the underlying ratings of AA-.

Tax and Revenue Anticipation Notes

2006 TRAN. Originally, TRANs were issued at tremendous rate advantages to taxable reinvestment rates, often producing 2 percent excess returns when the General Fund had excess cash and significantly lowering the borrowing cost when the balances were negative. ALCo authorized the 2006 (FY2007) TRAN program in an amount not to exceed $600 million. An historically high fiscal year beginning balance resulted in a reduced TRAN size. On July 3, 2006, $150 million was delivered to mature on June 28, 2007. The 2006 Series A TRANs were sold by Citigroup Global Markets Inc. on June 21, 2006. The fixed rate notes carry a coupon of 4.50 percent to yield 3.70 percent. The net benefit to the General Fund is expected to be approximately $2.5 million.

ALCo entered into an Interest Rate Swap with JP Morgan Chase Bank, N.A. to partially hedge the 2006 TRAN. The Commonwealth will receive a 5.61 percent fixed rate on $150 million notional amount (1.75 percent above cost of funds) while paying one-month LIBOR. The start date for the swap was July 3, 2006 with a maturity of June 28, 2007.

FINANCIAL AGREEMENTS

As of December 31, 2006, ALCo had ten financial agreements outstanding, with a net notional amount exposure of $300 million. There were four financial agreements executed during the period. The terms of these transactions are summarized below and in Appendix A.

General Fund

In January 2006, to protect against a rise in interest rates, ALCo competitively bid and subsequently entered into two (2) $80 million interest rate swap transactions with three counterparties to hedge the future issuance of $300 million of permanent tax-exempt bonds for General Fund authorized but unissued projects. The 2007 and 2008 forward-starting swap agreements featured mandatory early termination dates of February 14, 2007 and February 13, 2008, respectively. The hedges allowed the fiscal year 2007 and fiscal year 2008 debt service to be appropriated at 4.40 percent rather than the budgeted template rate of 6.50 percent. This resulted in annual savings (reduction in appropriation) to the General Fund of $4,445,000.

In September 2006, the 2008 swap was converted from LIBOR to BMA to limit the basis risk between the taxable and tax-exempt yield curves. This conversion was accomplished by first executing a second $80 million LIBOR based interest rate swap with ALCo now receiving the fixed receiver rate. This transaction effectively offset the original LIBOR swap and allowed ALCo to lock in a spread of 29.5 basis points between the fixed rate legs of the two swaps. Secondly, a $150 million BMA based interest rate swap was executed with ALCo paying a fixed rate of 4.085 percent. These transactions resulted in further annual savings (reduction in appropriation) to the General Fund of $335,000. Each of these transactions was competitively bid. UBS, Citigroup and JP Morgan are counterparties to these transactions.

In November 2006, the 2007 swap was converted from LIBOR to BMA as well, once again to limit basis risk and to lock in a fixed spread providing further savings to the General Fund. Each transaction was competitively bid. UBS, Citigroup and JP Morgan were again counterparties in these transactions. Subsequently, on February 14, 2007 the 2007 swaps were terminated and the resulting net savings amount of $596,500 was used to reduce the amount of SPBC 87 bonds sold that same day to permanently finance General Fund supported bond projects.

Road Fund

Of the outstanding Road Fund financial agreements, the first item is a Total Return swap related to the $56,485,000 July 1, 2009 maturity of the TAK Resource Recovery 1985 Series A Bonds, which bears interest at 6 percent. Staff worked for approximately 18 months to develop this transaction with Morgan Stanley ("MS") and finally executed the trade in April 2001. The 1985A Bonds could not be economically refunded, despite a very low interest rate environment, due to the enormous transferred proceeds penalty associated with the Debt Service Reserve Fund ("DSRF") which is earning approximately 10 percent. MS, bond counsel and the Commonwealth developed a structure, whereby the bonds would be called, but not redeemed. Once called, the bonds were sold to MS. ALCo then entered into a total rate of return swap, whereby MS pays ALCo 6 percent (the coupon on the bonds) and ALCo pays to MS, BMA (short-term tax-exempt municipal index) plus a spread (currently 58 basis points) to cover expenses. This transaction provided the synthetic variable rate exposure to offset the asset sensitivity in the balance sheet, i.e. sensitivity to declining interest rates. Rates continued to steadily decline, putting the trade in a very favorable position. Shortly after the events of September 11, 2001, interest rates tumbled dramatically and on September 27, 2001, staff entered into an offsetting trade, locking in a guaranteed spread of 213 basis points. The reversal rate (rate ALCo agrees to pay MS) was 3.87 percent versus the original fixed receiver rate of 6 percent from MS. ALCo has received $5.1 million under the terms of the agreements since inception. The expected total benefit from this transaction to maturity is $7.46 million.

Since the two transactions offset each other for a net notional amount of zero, ALCo collects the difference between the two payments and deposits the proceeds into a swap account held for the benefit of the Road Fund. This account also secures future payments to MS under the agreement, if necessary. ALCo is obligated under the agreement to accumulate a minimum balance of $3 million in the swap account. Once cumulative deposits have achieved that level, funds may be available to offset future debt service payments. Since the bonds are still outstanding and the TAK retains the right to call the bonds at face value (par), the termination value of the swap is essentially the present value of the fixed expenses (13 basis points). In the event that rates rise above the coupon on the bonds, the transaction would be terminated and the bonds would be resold to the marketplace. If the value of the bonds in the market is below par, then ALCo would make a payment from the swap account to MS equal to the difference between the then market value and par. Alternatively, the Road Fund could purchase the bonds as an investment at par. The Road Fund and the TAK get the best of both worlds with this transaction in that they retain the highly valuable DSRF earning 10 percent and lower the cost of borrowing as long as interest rates stay low. In the event that interest rates rise dramatically, then the investment portfolio of the Road Fund will earn significantly more than projected so long as the Road Fund maintains an investable balance equal to or greater than the notional amount of the transaction. For tax purposes, the Total Return Swap must terminate prior to the final maturity of the bonds. The end date for the Total Return Swap is July 1, 2007.

ALCo also entered into an identical transaction with MS for the 5.50 percent bonds due July 1, 2007 of the TAK Toll Road 1986 Series A Bonds with a par amount of $50,920,000. The Toll Road DSRF earns a bit less than the Resource Recovery 1985A bonds and the coupon on the outstanding bonds is also less, but the mechanics are the same.

On July 24, 2001, MS agreed to enter into a total return swap whereby MS would pay ALCo beginning on January 3, 2002, 5.50 percent in exchange for BMA plus 45 basis points (to cover expenses). The trade could not be executed until December 7, 2001, after the call notice for the bonds had been issued. ALCo agreed to pay MS 4.15 percent in exchange for BMA plus 45 basis points, locking in a guaranteed spread of 135 basis points as long as BMA plus 45 basis points remain below the coupon of the bonds of 5.50 percent.

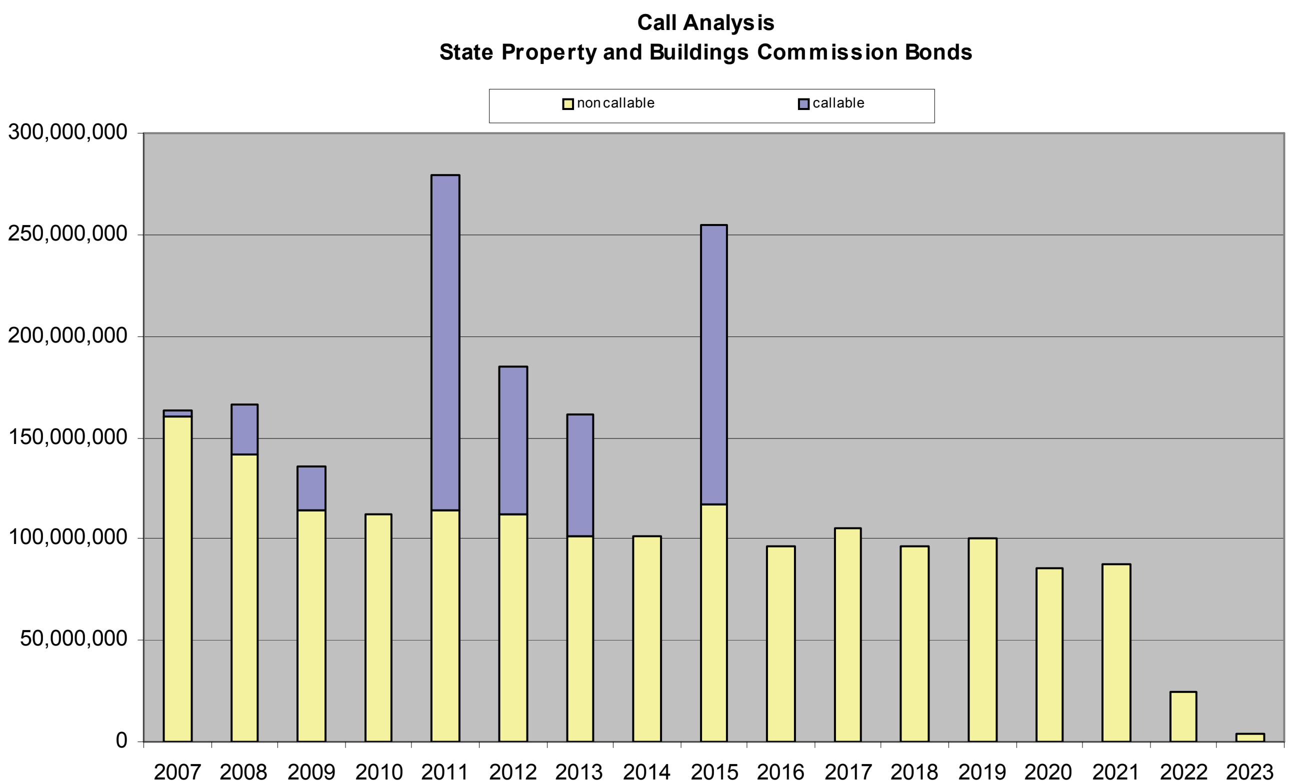
In 2003, the Federal Highway Administration awarded the state Transportation Cabinet approximately $13 million, the estimated remaining principal amount of the Toll Road Bonds related to the Toll Roads known as the Hal Rogers Daniel Boone Parkway and the Louie B. Nunn Cumberland Parkway. The award was granted with the understanding that the tolls would no longer be collected and the toll booths removed on these two roads. On July 1, 2003, the Total Return and Fixed Swap transactions were adjusted due to the $12,195,000 partial redemption of the 2007 term maturity of the Toll Road 1986 Series A Bonds. The $50,920,000 original notional amount was reduced with no obligation due from either party with respect to the unwound notional amount as the partial termination occurred on an interest payment date. A swap termination payment on the fixed portion in the amount of $705,000 was paid to MS.

The first leg of the original Total Return transaction matured on July 1, 2005, and as a result, the trade was extended to January 1, 2007. In December 2006, ALCo initiated a transaction with MS to unwind the offsetting fixed receiver transaction with settlement to occur simultaneously with the Total Return maturity. On January 1, 2007, the Total Return transaction matured and ALCo received a final net payment from MS of $130,369. This brought the total net savings achieved on the TAK Toll Road swaps to $1.8 million.

Asset/Liability Model

General Fund

The total SPBC debt portfolio as of December 31, 2006 had $2,158 million of bonds outstanding with a weighted average coupon of 5.26 percent, modified duration of 3.56 years, and a yield at market of 3.67 percent. The market yield increased by 3 basis points from the prior reporting period while modified duration decreased by 0.52 years. The average coupon reflects investor preference for callable premium bonds in the current market at a yield lower than corresponding par or discount coupon bonds. The $485 million callable portion had an average coupon of 5.06 percent. There is $2.5 million currently callable in fiscal year 2007, mainly the unrefunded SPBC 57 bonds.

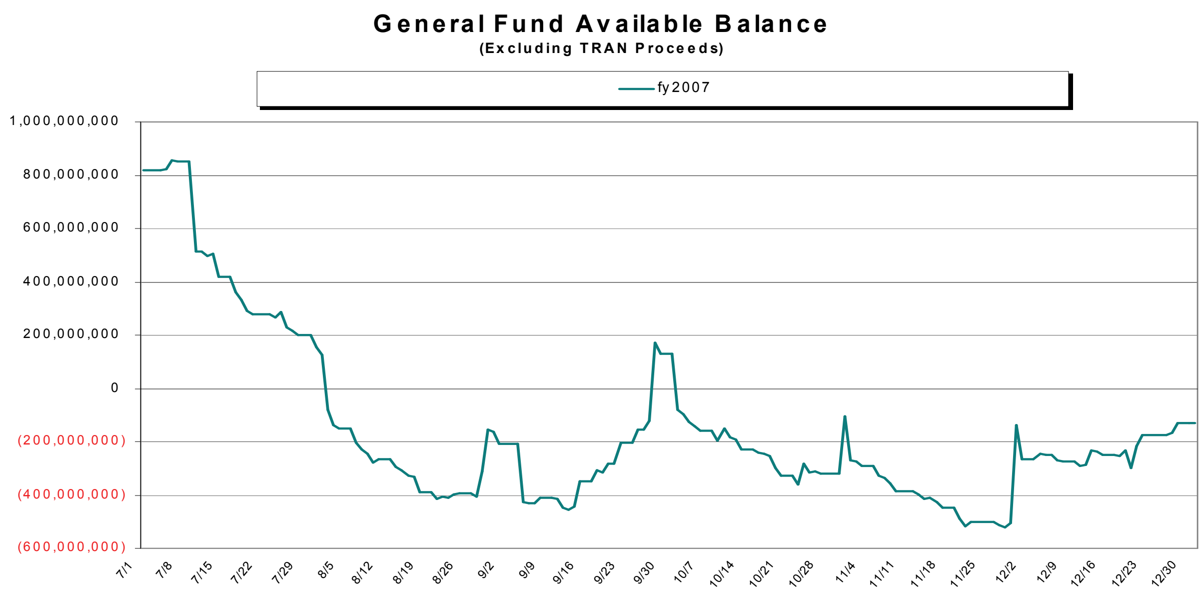


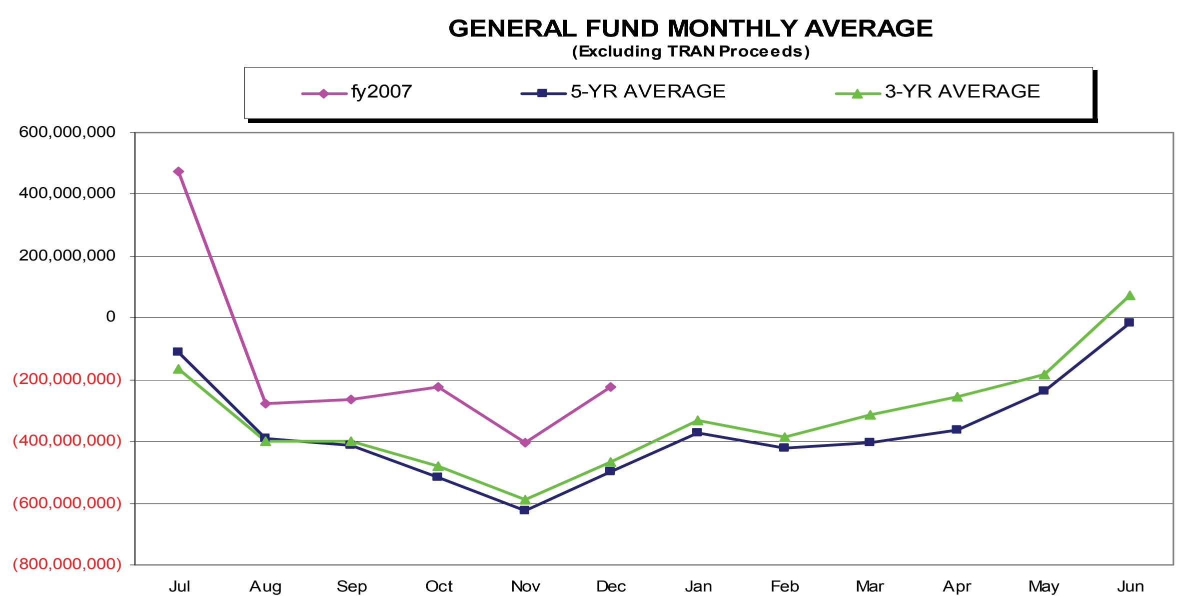
*This chart excludes the $4,335,000 SPBC 57 Bonds currently refunded by SPBC 87 in February 2007.

The SPBC General Fund debt structure has 30 percent of principal maturing in 5 years and 61 percent of principal maturing within 10 years. This is at the upper range of the rating agencies' proposed targets of 27-30 percent due in 5 years and 55-60 percent maturing within 10 years.

The General Fund had a high balance of $854 million on July 6, 2006 and a low of negative $520 million on November 28, 2006. The average and median balances were a negative $152 million and a negative $249 million, respectfully. Since the General Fund continued to have a negative available cash balance for most of the fiscal year, there is little, if anything, that can be done from an asset management viewpoint beyond current actions.

From a liability management perspective, total General Fund debt service, net of reserve fund credits, was $234 million for fiscal year to date 2007. Net Interest Margin will continue to be negative due to low cash balances versus outstanding fixed rate debt, low level of interest rates as well as the callability of the debt portfolio.





ALCo Project Notes, 2005 General Fund Second Series. Late in 2005, the remaining $640 million General Fund supported bond projects authorized by the 2005 General Assembly but not yet permanently financed were placed under an ALCo interim plan of finance. The 2005 General Fund Second Series Note program provides a funding mechanism that allows state agencies and universities to move forward with their capital projects prior to their need for permanent financing. In 2006, the Commission adopted resolutions to place the $1,243 million General Fund supported bond projects, authorized by the 2006 General Assembly under the same ALCo interim financing plan. The maximum authorized amount of notes outstanding under the program was increased from $750,000,000 to $950,000,000. The projects were placed under the program because they are not expected, at this time, to meet the IRS spend-down requirements of a traditional bond issue. OFM will monitor project expenditures and direct the issuance of notes as needed to meet current capital needs.

An initial tax-exempt tranche of $100,000,000, in two Series, was delivered on November 2, 2005. JP Morgan and UBS each provide remarketing services for the two separate $50 million Note Series, both issued in the commercial paper rate mode. The Note Series are each supported by a standby note purchase agreement provided by Dexia Credit Local, a leading European bank based in France, acting through its New York branch. Remarketing information and the cost of capital to date is provided in Appendix C.

As of December 31, 2006, the bond projects had expended $110 million.

Subsequent to December 31, 2006:

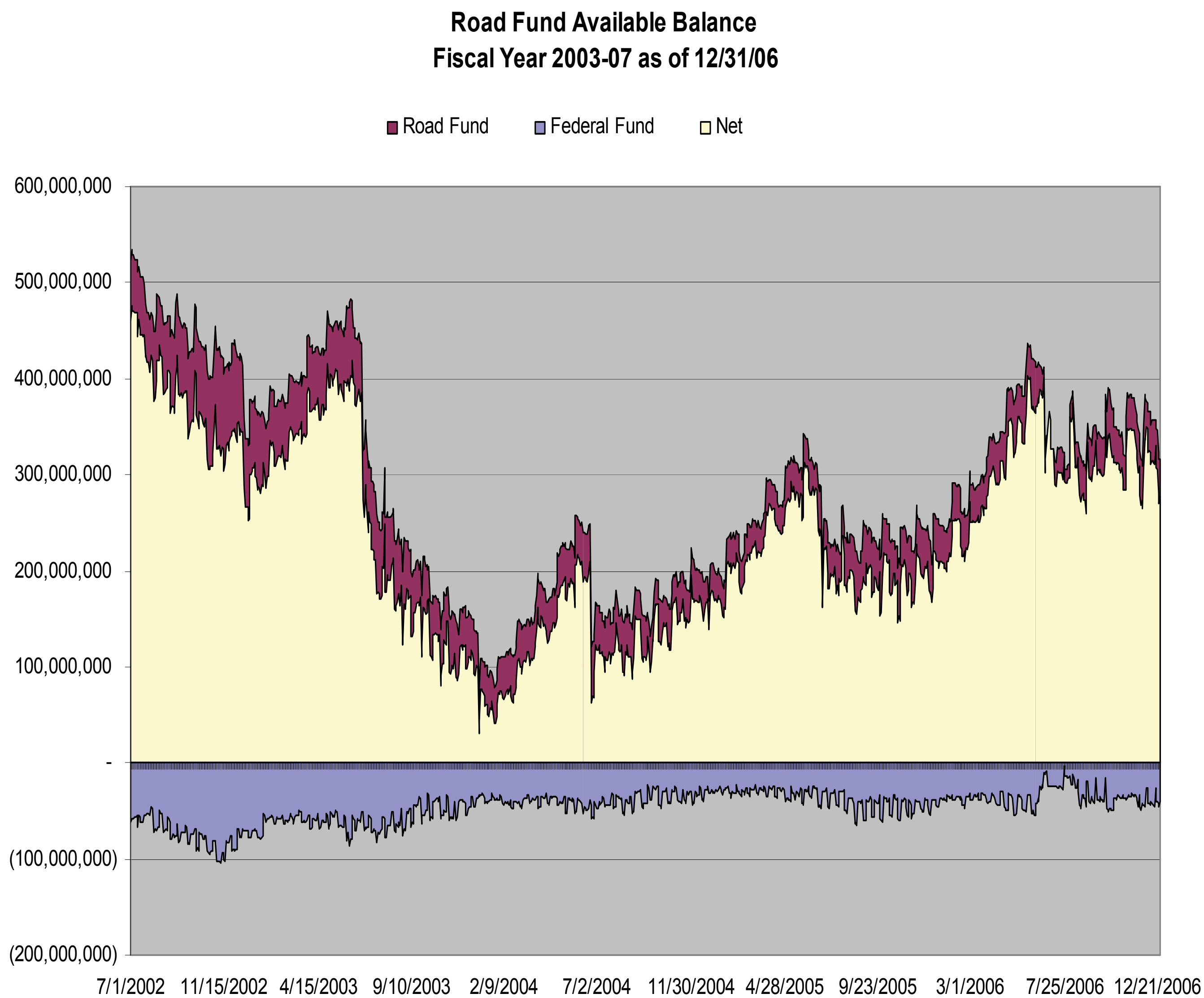
- An additional tax-exempt tranche of $100,000,000, in two Series, was delivered on January 17, 2007. The two separate $50 million Note Series again were issued in the commercial paper mode and are serviced by JP Morgan, UBS and Dexia.

- In February 2007, SPBC issued its Revenue and Revenue Refunding Bonds, Project No. 87, which currently refunded the first $100,000,000 tranche of ALCo 2005 General Fund Second Series Notes, a $5 million project previously funded with ALCo Agency Fund Notes and select maturities of SPBC 57. SPBC 87 permanently finances a total of $278,441,000 of General Fund supported bond projects authorized by the 2005 and 2006 General Assemblies. See the Project List in Appendix D.

ALCo Project Notes, 2005 General Fund First Series. Project proceeds of $81,850,000 ALCo 2005 General Fund First Series delivered on June 8, 2005 to provide for the financing of the Phase II Tobacco Settlement Payments were returned to the state in late 2005. The proceeds have been yield restricted and applied to General Fund supported bond projects, specifically the infrastructure for economic development fund for tobacco counties. As of December 31, 2006, $7.3 million of the proceeds had been expended on projects.

Road Fund

The 2005 General Assembly authorized $450 million of Road Fund supported TAK Economic Development Road Revenue Bonds for revitalization projects. One half of the project was financed in April 2005. The remaining bonds were sold in February 2006 with $75 million delivered in March and $150 million delivered in June 2006. As of December 31, 2006, $242 million of the bond proceeds had been expended. The 2006 General Assembly authorized an additional $350 million of Road Fund supported Economic Development Bonds to be sold after July 1, 2006. No Road Fund supported notes or bonds were issued by ALCo or TAK during the reporting period. The timing of the issuance of future bonds is uncertain.



The Road Fund average daily cash balance for the first half of fiscal year 2007 was $339 million compared to $235 million for the first half of fiscal year 2006. The Road Fund cash was invested in the Intermediate Term Investment Pool which had a duration of 1.02 years as of December 31, 2006. The Road Fund earned $6.8 million on a cash basis for fiscal year-to-date 2007 versus $1.3 million for the same period in fiscal year 2006. The continued relatively low level of investable balances and the large debt authorization limits the opportunity to implement new asset liability management strategies at this time.

As of December 31, 2006, TAK had $982 million of bonds outstanding with a weighted average coupon of 4.84 percent, modified duration of 3.83 years and yield at market of 3.76 percent. Selected maturities of the Resource Recovery 1985A with the most economical value are associated with the financial agreements identified previously. The final Road Fund debt service appropriation for the Toll Road 1986 A bonds was deposited with the trustee on November 1, 2006, allowing for the collapse of the Toll Road indenture and the removal of the remaining tolls. The Debt Service Reserve will be sufficient to pay the final debt service payment on July 1, 2007.

Road Fund debt service paid, net of reserve fund credits for fiscal year-to-date 2007, was $23.2 million resulting in a net interest margin (investment income earned less debt service paid) of negative $16.4 million. The negative amount stems from the level of investable balances and a general low level of interest rates on the investment side and limited callability of fixed rate obligations on the liability side. While cash balances have improved, they are not sufficient to offset interest expenses.

Agency Fund

ALCo University of Kentucky General Receipts Project Notes. In October of 2006, ALCo issued $146,430,000 of University of Kentucky General Receipts Project Notes. The notes were issued under the University's General Receipts Indenture and were comprised of three separate series, $66,305,000 of General Receipts Refunding Project Notes, 2006 Series A, $2,220,000 of General Receipts Taxable Refunding Project Notes, 2006 Series B, and $77,905,000 of General Receipts Project Notes, 2007 Series A. The 2006 Series A and B notes were issued to refund all of the University's outstanding Housing and Dining System bonds, and select SPBC Agency Fund bonds, while the 2007 Series A notes were issued to fund $75,000,000 of the cost of expanding and renovating the existing University Hospital, as well as the addition of a parking structure and overhead concourse to the new addition. The 2007 Series A notes were issued on a forward delivery basis with delivery expected on November 1, 2007. The University's Consolidated Educational Buildings Revenue Bonds remain outstanding in the amount of $139,170,000 with a final maturity of May 2024.

ALCo Project Notes, 2005 Agency Fund Second Series. Agency Fund supported bond projects not already financed by a university, ALCo or SPBC have been placed under an ALCo interim plan of finance. The ALCo Agency Fund Second Series Note Program allows various state universities and state agencies to receive funding for their projects as needed. The Program's initial draws were for projects for the Cabinet for Economic Development (Series A-1) and for the University of Louisville (Series A-2), both delivered on December 15, 2005. Additional draws on the program have been for projects for Northern Kentucky University (Series A-3) delivered on March 20, 2006 with a subsequent draw delivered on October 4, 2006 (Series A-3 (1)) and for Western Kentucky University (Series A-4) delivered on June 29, 2006. The Notes have a variable interest rate, reset weekly, based on a fixed spread to BMA to be determined by the rating assigned to the Note Series. The private placement of the Notes is with Citigroup Global Markets, Inc. At December 31, 2006, $27,430,000 was outstanding under the not to exceed $250,000,000 Note Program. The $5,085,000 principal outstanding for the Series A-1 Notes was refunded by SPBC 87 in February 2007. The University of Louisville made a principal payment of $1,300,000 on the Series A-2 Notes on January 4, 2007. The remaining balance of $8,380,000 was refunded by the University of Louisville's first General Receipts bond issue in March 2007. Presently, all the series have received ratings of A1 by Moody's and have been priced at BMA plus 45 basis points.

SUMMARY

ALCo's approach to managing the Commonwealth's interest-sensitive assets and interest-sensitive liabilities continues to produce excellent results.

Investments. At fiscal year end 2003, incremental returns derived from new investment asset classes reached $27 million since inception. The program continues but is no longer monitored for incremental value.

Cash Management. Cash management improved dramatically with the implementation of the General Fund TRAN program producing $3.2 million in fiscal year 1998, $4.7 million in fiscal year 1999 and $7.3 million in fiscal year 2000. Economic benefit for fiscal year 2001 was $6.5 million, fiscal year 2002 was $4.3 million and fiscal year 2003 was $0.3 million. No TRAN was issued in fiscal year 2004. In fiscal year 2005, the TRAN provided $2.8 million net benefit and $6 million in fiscal year 2006. In fiscal year 2007, the TRAN is expected to produce a net income of approximately $2.5 million for a cumulative benefit of $38 million.

Debt Management. Debt service savings have contributed an estimated $367 million in value added since inception. ALCo continues to analyze potential opportunities for savings and to evaluate new financing structures which offer the Commonwealth the ability to diversify risk within its portfolio while taking advantage of market demand for various new products.

Total value added since inception is in excess of $432 million.

APPENDIX

APPENDIX A
SWAP SUMMARY

ALCo General Fund	LIBOR			reverse LIBOR	BMA	
2007 Financial Agreements	$80,000,000				$150,000,000	
Notional Amount	40,000,000	20,000,000	20,000,000	$80,000,000	75,000,000	75,000,000
Fund Source	----------	General Fund	----------	General Fund	General Fund	
Hedge	----------	Net Interest Margin	----------	Net Interest Margin	Net Interest Margin	
Counter-Party	UBS	Citibank	JPMorgan	JPMorgan	UBS	JPMorgan
Counter-Party Ratings*	Aa2/AA+/AA+	Aa1/AA/AA+	Aa3/A+/A+	Aa3/A+/A+	Aa2/AA+/AA+	Aa3/A+/A+
Termination Trigger	A3/A-	Baa3/BBB-	Baa3/BBB-	Baa3/BBB-	A3/A-	Baa3/BBB-
Swap Type	----------	Fixed Pay	----------	Floating Rate Payer	Fixed Pay	
Benchmark	----------	3 month LIBOR	----------	3 month LIBOR	BMA	
Reset	----------	Weekly	----------	Weekly	Weekly	
Amortize (yes/no)	----------	yes	----------	yes	yes	
Execution Date	----------	1/10/2006	----------	11/14/2006	11/14/2006	
Start Date	----------	2/14/2007	----------	2/14/2007	2/14/2007	
Mandatory Early Termination	----------	2/14/2007	----------	2/14/2007	2/14/2007	
Cash Settlement Payment Date	----------	2/28/2007	----------	2/28/2007	2/28/2007	
End Date	----------	2/14/2027	----------	2/14/2027	2/14/2027	
Fixed Rate pay-(rec)	----------	5.008%	----------	-5.086%	3.773%	
Day Count	----------	30/360	----------	30/360	30/360	
Payment Dates	----------	quarterly	----------	quarterly	quarterly	
Security Provisions	Bonds payable from General Fund			Bonds payable from General Fund	Bonds payable from General Fund	

* *Moody's, S & P, Fitch*

ALCo General Fund	LIBOR			reverse LIBOR			BMA	
2008 Financial Agreements	$80,000,000			$80,000,000			$150,000,000	
Notional Amount	40,000,000	20,000,000	20,000,000	40,000,000	20,000,000	20,000,000	75,000,000	75,000,000
Fund Source	----------	General Fund	----------	----------	General Fund	----------	General Fund	
Hedge	----------	Net Interest Margin	----------	----------	Net Interest Margin	----------	Net Interest Margin	
Counter-Party	UBS	Citibank	JPMorgan	UBS	Citibank	JPMorgan	UBS	Citibank
Counter-Party Ratings*	Aa2/AA+/AA+	Aa1/AA/AA+	Aa3/A+/A+	Aa2/AA+/AA+	Aa1/AA/AA+	Aa3/A+/A+	Aa2/AA+/AA+	Aa1/AA/AA+
Termination Trigger	A3/A-	Baa3/BBB-	Baa3/BBB-	A3/A-	Baa3/BBB-	Baa3/BBB-	A3/A-	Baa3/BBB-
Swap Type	----------	Fixed Pay	----------	----------	Floating Rate Payer	----------	Fixed Pay	
Benchmark	----------	3 month LIBOR	----------	----------	3 month LIBOR	----------	BMA	
Reset	----------	Weekly	----------	----------	Weekly	----------	Weekly	
Amortize (yes/no)	----------	yes	----------	----------	yes	----------	yes	
Execution Date	----------	1/10/2006	----------	----------	9/15/2006	----------	9/15/2006	
Start Date	----------	2/13/2008	----------	----------	2/13/2008	----------	2/13/2008	
Mandatory Early Termination	----------	2/13/2008	----------	----------	2/13/2008	----------	2/13/2008	
Cash Settlement Payment Date	----------	2/27/2008	----------	----------	2/27/2008	----------	2/27/2008	
End Date	----------	2/13/2028	----------	----------	2/13/2028	----------	2/13/2028	
Fixed Rate pay-(rec)	----------	5.038%	----------	-5.335%	-5.340%	-5.323%	4.085%	
Day Count	----------	30/360	----------	----------	30/360	----------	30/360	
Payment Dates	----------	quarterly	----------	----------	quarterly	----------	quarterly	
Security Provisions	Bonds payable from General Fund			Bonds payable from General Fund			Bonds payable from General Fund	

** Moody's, S&P, Fitch*

Road Fund

Financial Agreements

	TAK RR 85A Total Return	TAK RR 85A Fixed	TAK TR 86A Total Return	TAK TR 86A Fixed
Fund Source	Road Fund	Road Fund	Road Fund	Road Fund
Hedge	Net Interest Margin	Total Return	Net Interest Margin	Total Return
Counter-Party	Morgan Stanley	Morgan Stanley	Morgan Stanley	Morgan Stanley
Counter-Party Ratings*	Aa3/A+/AA-	Aa3/A+/AA-	Aa3/A+/AA-	Aa3/A+/AA-
Termination Trigger	BBB-/Baa3	BBB-/Baa3	BBB-/Baa3	BBB-/Baa3
Swap Type	Variable Pay	Fixed Pay	Variable Pay	Fixed Pay
Benchmark	BMA	BMA	BMA	BMA
Reset	Weekly	Weekly	Weekly	Weekly
Notional Amount	56,485,000	56,485,000	21,130,000	21,130,000
Amortize (yes/no)	no	no	yes	yes
Execution Date	4/23/2001	9/20/2001	7/24/2001	7/24/2001
Start Date	5/24/2001	9/27/2001	1/3/2002	1/3/2002
End Date	7/1/2007	7/1/2009	1/1/2007	1/1/2007
Fixed Rate pay-(rec)	(6.000%)	3.870%	(5.50%)	4.150%
Day Count	30/360	30/360	30/360	30/360
Payment Dates	Jan. 1 & July 1	Jan. 1 & July 1	Jan. 1 & July 1	Jan. 1 & July 1
Security Provisions	Road Fund Inv.	Road Fund Inv.	Road Fund Inv.	Road Fund Inv.
Current Market Valuation December 31, 2006	0.00	0.00	0.00	0.00
Interest Earnings				
Cumulative Prior Periods	147,727	4,481,206	0.00	1,651,082
Current Period - 12/31/2006	0.00	432,768	0.00	130,369
Total	147,727	4,913,974	0.00	1,781,451

* *Moody's, S&P, Fitch*

Swap Summary

As of December 31, 2006:

Total Notional Amount Executed		Net Exposure Notional Amount	
General Fund	Road Fund	General Fund	Road Fund
620,000,000	155,230,000	300,000,000	0

Total Notional Amount Executed by Counter Party

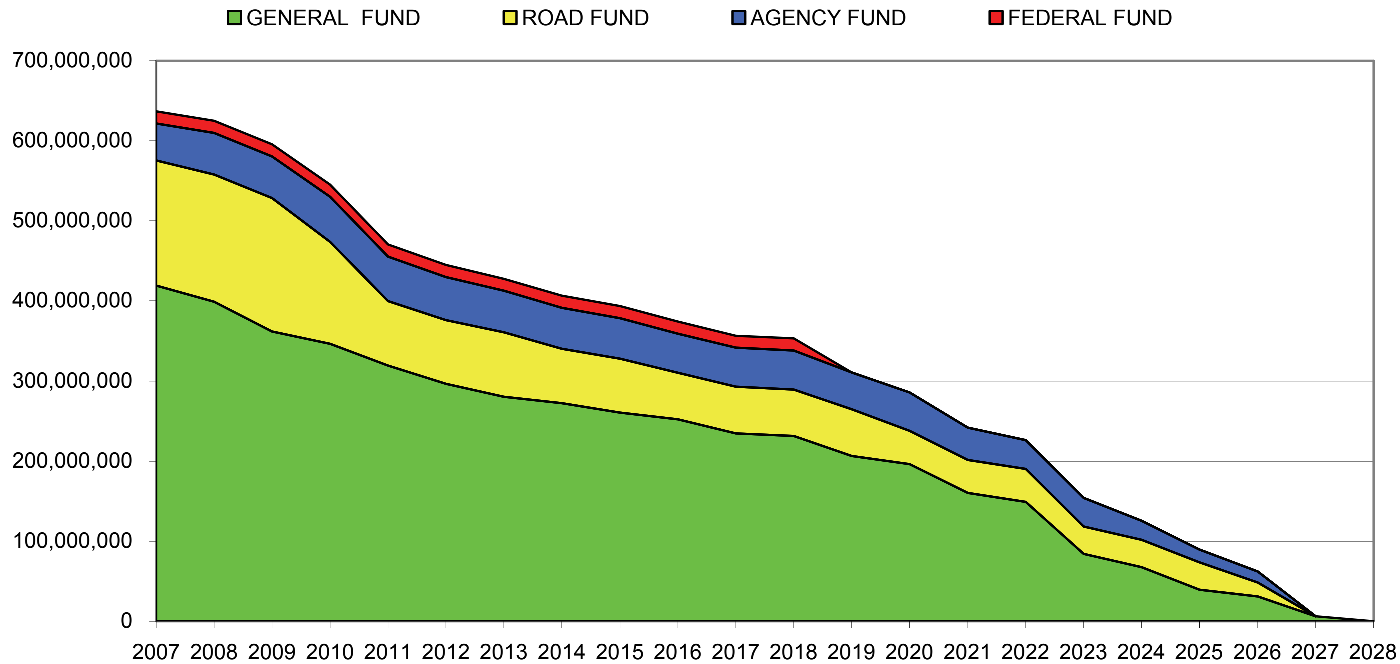
Morgan Stanley	UBS	Citibank	JPMorgan
155,230,000	270,000,000	135,000,000	215,000,000

	Debt		10 Percent Net Exposure	
	General Fund	Road Fund	General Fund	Road Fund
Bonds Outstanding	2,113,845,351	1,056,776,344	211,384,535	105,677,634
Authorized but Unissued	1,608,754,000	350,000,000	160,875,400	35,000,000
Total	3,722,599,351	1,406,776,344	372,259,935	140,677,634

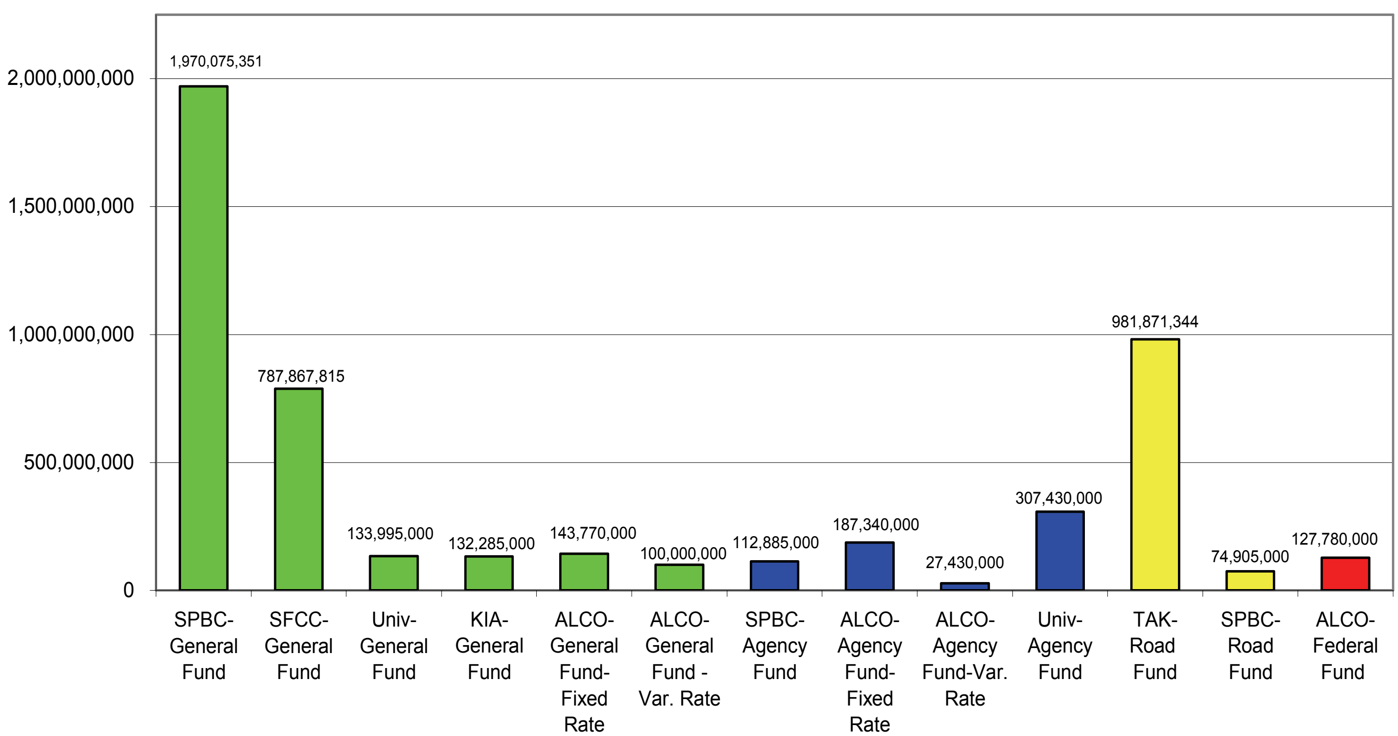
Investment Pool Balance		10 Percent Investment Portfolio	
Other Funds	Net Road Fund	Other Funds	Net Road Fund
3,475,785,665	316,322,836	347,578,567	31,632,284

APPENDIX B

Appropriation Supported Debt Service
by Fund Source
as of 12/31/06
(Fixed Rate Debt Only)



Appropriation Debt Principal Outstanding
by Fund Source
as of 12/31/06
(Variable Rate Debt = Bond Anticipation Notes)



APPENDIX C

COMMONWEALTH OF KENTUCKY
ASSET/LIABILITY COMMISSION
SCHEDULE OF NOTES OUTSTANDING
as of 12/31/2006

FUND TYPE SERIES TITLE		AMOUNT ISSUED	DATE OF ISSUE	MATURITY DATE	PRINCIPAL OUTSTANDING
General Fund Project Notes					
2001 1st Series		$37,450,000	2/2001	2/2008	$11,925,000
2003 Series A		$171,260,000	7/2003	7/2013	$52,985,000
2005 1st Series		$81,850,000	6/2005	5/2025	$78,860,000
2005 2nd Series		$100,000,000	11/2005	11/2025	$100,000,000
	FUND TOTAL	**$390,560,000**			**$243,770,000**
Agency Fund Project Notes*					
2005 1st Series		$11,275,000	6/2005	6/2025	$11,275,000
2005 Series A-UK General Receipts		$107,540,000	11/2005	11/2025	$107,540,000
2006 Series-UK General Receipts		$68,525,000	10/2006	10/2022	$68,525,000
2005 2nd Series					
Series A-1	Econ Dev	$5,085,000	12/2005	4/2009	$5,085,000
Series A-2	UL	$10,530,000	12/2005	4/2009	$9,680,000
Series A-3	NKU	$10,000,000	3/2006	4/2009	$10,000,000
Series A-4	WKU	$2,665,000	6/2006	4/2009	$2,665,000
	FUND TOTAL	**$215,620,000**			**$214,770,000**
Federal Hwy Trust Fund Project Notes					
2005 1st Series		$139,635,000	6/2005	9/2017	$127,780,000
	FUND TOTAL	**$139,635,000**			**$127,780,000**
TRAN 2006		$150,000,000	7/2006	6/2007	$150,000,000
	FUND TOTAL	**$150,000,000**			**$150,000,000**
ALCo TOTAL		**$895,815,000**			**$736,320,000**

*Excludes the $77,905,000 ALCo 2007 Series A-UK General Receipts Project Notes which were issued on a forward delivery basis in October 2006 with an expected delivery date of November 1, 2007.

Kentucky Asset/Liability Commission

Variable Rate Debt

Weighted Average Yields - Cost of Capital

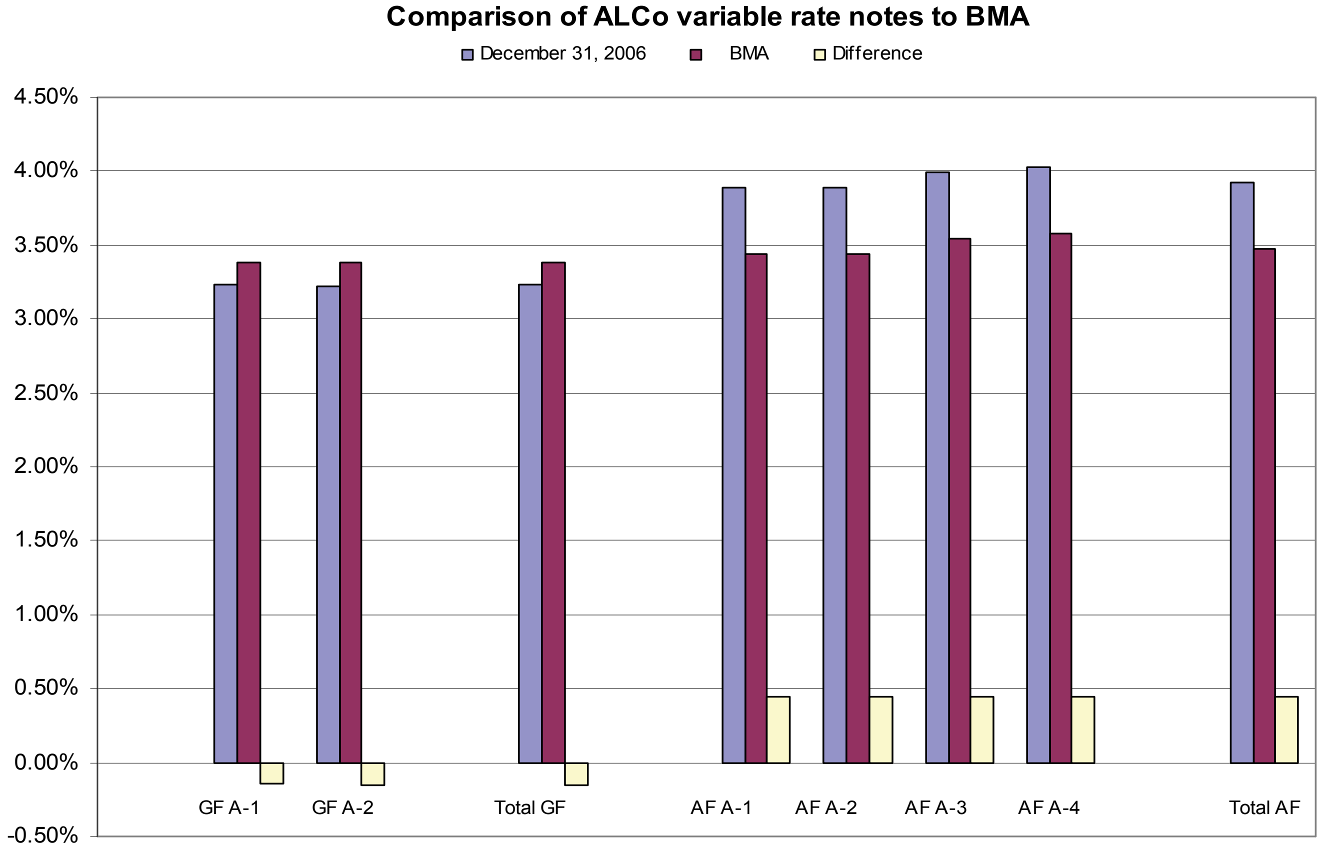
	2005 General Fund Second commercial paper			2005 Agency Fund Second (1) BMA + 0.45% weekly reset				
	Series A-1	Series A-2	**Total**	Series A-1	Series A-2	Series A-3	Series A-4	**Total**
Program Size	*not to exceed $950 million*			*not to exceed $250 million*				
Amount Issued	$50,000,000	$50,000,000	**$100,000,000**	$5,085,000	$10,530,000	$10,000,000	$2,665,000	**$28,280,000**
Amount Outstanding	$50,000,000	$50,000,000	**$100,000,000**	$5,085,000	$9,680,000	$10,000,000	$2,665,000	**$27,430,000**
Initial Date of Issue	2-Nov-05	2-Nov-05		15-Dec-05	15-Dec-05	20-Mar-06	29-Jun-06	
Agency	- - -	various	- - -	Econ Dev	UL	NKU	WKU	
Project Amount Authorized	- - -	$1,969,445,000	- - -	$5,000,000	$45,827,000	$47,510,000	$54,000,000	**$152,337,000**
December 31, 2006								
BMA	3.385%	3.385%		3.439%	3.439%	3.548%	3.577%	
Average Notes Outstanding	$50,000,000	$50,000,000	**$100,000,000**	$5,085,000	$10,131,702	$7,240,418	$2,665,000	**$21,954,110**
Inception Weighted Yields	3.237%	3.225%	**3.231%**	3.889%	3.889%	3.998%	4.027%	**3.923%**
Cost of Issuance				0.207%	0.115%	0.142%	0.118%	**0.143%**
Remarketing Fee	0.050%	0.050%	**0.050%**	-	-	-	-	**-**
Liquidity Facility Fee	0.075%	0.075%	**0.075%**	-	-	-	-	**-**
Average Cost of Funds	**3.363%**	**3.351%**	**3.357%**	**4.097%**	**4.005%**	**4.139%**	**4.145%**	**4.067%**

(1) Agency Fund 2005 Second Series:

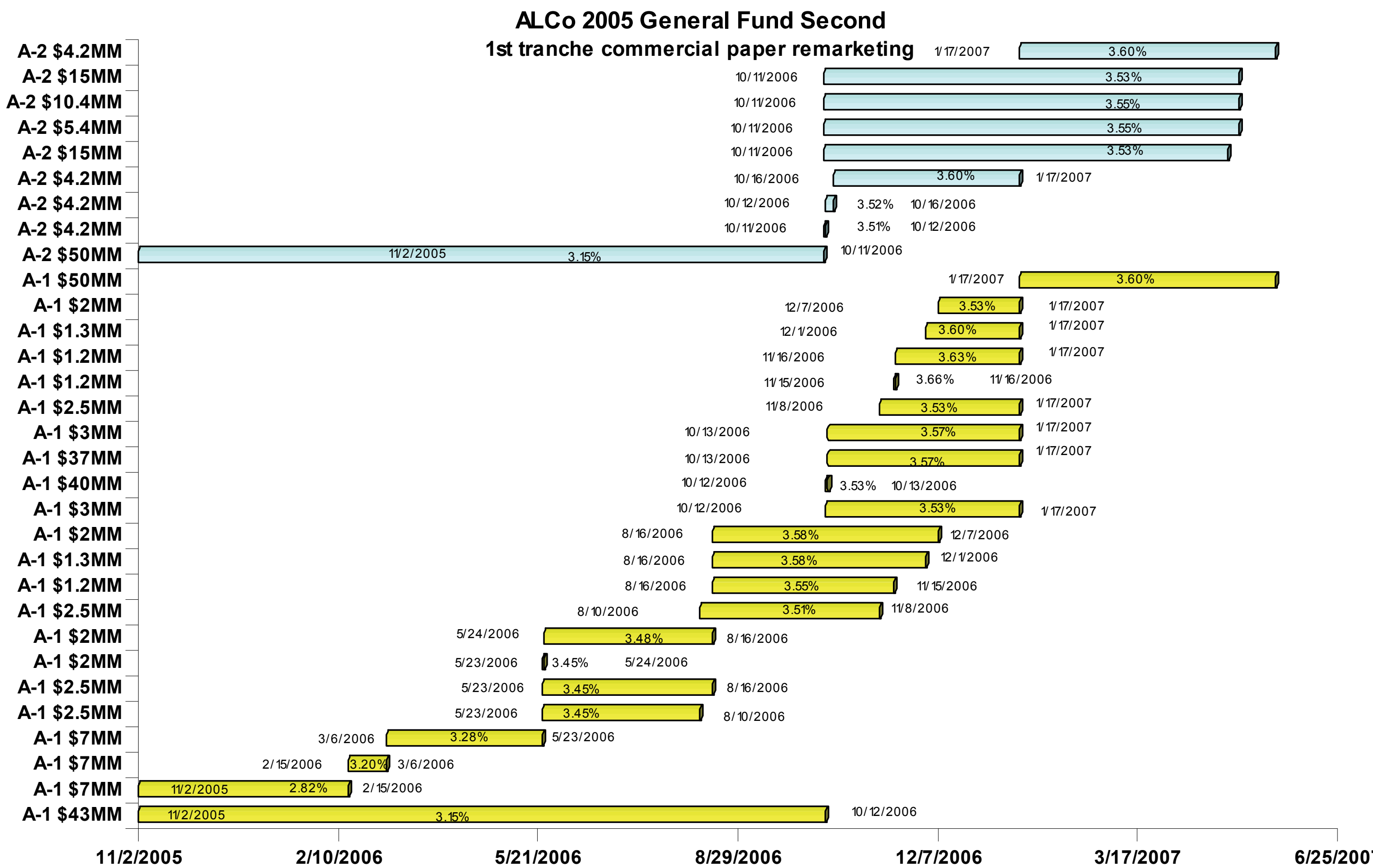
Trustee fee of $6,000 distributed evenly to each series

Fees allocated as percentage of Total Authorized Amount for each respective project

Each Series has been rated A1 by Moody's.



Comparison of ALCo variable rate notes to BMA
December 31, 2006
BMA
Difference
4.50%
4.00%
3.50%
3.00%
2.50%
2.00%
1.50%
1.00%
0.50%
0.00%
-0.50%
GF A-1
GF A-2
Total GF
AF A-1
AF A-2
AF A-3
AF A-4
Total AF



ALCo 2005 General Fund Second
1st tranche commercial paper remarketing
A-2 $4.2MM
A-2 $15MM
A-2 $10.4MM
A-2 $5.4MM
A-2 $15MM
A-2 $4.2MM
A-2 $4.2MM
A-2 $4.2MM
A-2 $50MM
A-1 $50MM
A-1 $2MM
A-1 $1.3MM
A-1 $1.2MM
A-1 $1.2MM
A-1 $2.5MM
A-1 $3MM
A-1 $37MM
A-1 $40MM
A-1 $3MM
A-1 $2MM
A-1 $1.3MM
A-1 $1.2MM
A-1 $2.5MM
A-1 $2MM
A-1 $2MM
A-1 $2.5MM
A-1 $2.5MM
A-1 $7MM
A-1 $7MM
A-1 $7MM
A-1 $43MM
11/2/2005
2/10/2006
5/21/2006
8/29/2006
12/7/2006
3/17/2007
6/25/2007

APPENDIX D

PROJECT LIST

General Fund supported Bonds Authorized by the 2005 and 2006 General Assembly

State Property and Buildings Commission Revenue Bonds, Project No. 85

Agency	Project Title	Amount [1]
Commerce Cabinet		
Kentucky Horse Park	Horse Park Indoor Arena – Design	$1,500,000
Department of Parks	Herrington Lake State Park and Lodge – Design and Land Acquisition	2,000,000
Department of Parks	Kincaid Lake Lodge – Design and Engineering	500,000
Department of Parks	Parks Renovation Pool	35,000,000
Education Cabinet		
Department of Education	Butler County Area Vocational Center	1,500,000
Department of Education	Letcher County Central Vocational Center	2,000,000
Department of Education	Russell County Learning Center	3,500,000
Council on Postsecondary Education		
	Biotechnology Building – Shrimp Production	1,700,000
KCTCS	Franklin Technology Center	12,000,000
KCTCS	Owensboro Technology Center	13,088,000
KCTCS	Warren County Technology Center	7,500,000
Morehead State University	Clay Community Center – Eight Additional Classrooms	1,500,000
Cabinet for Economic Development		
	Crispus Attucks – Small Business Incubator	250,000
	Gallatin County/Argent Metals Technology	200,000 [2]
	Montgomery County/Nestle Prepared Foods	100,000 [2]
	Warren County/Retail Logic, Inc. (Pan-Oston)	340,000 [2]
	Warren County/South Central Ky. Regional Dev. Authority/Bowling Green Metalforming LLC (Magna)	1,500,000 [2]
Environmental and Public Protection Cabinet		
Division of Waste Management	Petroleum Storage Tank Environmental Assurance Fund	25,000,000
Finance and Administration Cabinet		
	Renovate State Office Bldg. Phase II	35,000,000
	Statewide Repair, Maintenance, and Replacement Pool Fund	18,225,000
Governor's Office for Local Development		
	Community Economic Growth Program	10,000,000
	E.P. Tom Sawyer Park	400,000
	Knox Partners Community Education Center	2,000,000
	Louisville Science Center	700,000
	Louisville Zoo	750,000
Kentucky Infrastructure Authority	Infrastructure for Economic Development Fund for Coal- Producing Counties	20,000,000 [3]
Kentucky Infrastructure Authority	Infrastructure for Economic Development Fund for Tobacco Counties	31,500,000 [3]
Department of Military Affairs	Various Facilities – Deferred Maintenance	2,300,000
TOTAL		**$230,053,000**

[1] Excludes allocable costs of issuance.

[2] Economic Development Bond Pool Reauthorization.

[3] Represents one-fourth of the Authorized Project Amount.

State Property and Buildings Commission Revenue and Revenue Refunding Bonds, Project No. 87

Agency	Project Title	Amount	[1]
Kentucky State Fair Board	Design East Wing/Hall Renovation Project	$50,000,000	
Cabinet for Economic Development	City of Danville/3B, Inc.	200,500	[2]
	Lexington - Fayette Urban Co. Gov./Belcan Engineering Group, Inc.	500,000	[2]
	City of Franklin/HBAS Manufacturing, Inc. (formerly Harmon Becker Automotive Systems Inc.)	196,500	[2]
	Caldwell County/Hydro-Gear Limited Partnership	100,000	[2]
	Hopkins County/Land O Frost	450,000	[2]
	Hart County/T. Marzetti Company	125,000	[2]
	Pulaski County/UGN, Inc.	300,000	[2]
	Airport Relocation Assistance	5,000,000	[3,5]
Education Cabinet	Department of Education - Facility for Education Arts Programs	1,800,000	
	Department of Education - Rockcastle Area Vocational Technical School	8,000,000	
	Department of Education – Various Major Maintenance - KSD	3,839,000	
	Kentucky Educational Television - Replace Roof at Network Center	1,000,000	
	Vocational Rehabilitation - Replace Roof Perkins Rehabilitation Center	1,320,000	
Environmental and Public Protection Cabinet	Environmental Protection - State-Owned Dam Repair	1,000,000	
Finance and Administration Cabinet	COT - Public Safety Communications Infrastructure - KEWS	13,768,000	
Governor's Office of Agricultural Policy	Kentucky Agriculture Finance Corporation - Loan Pool	10,000,000	[4]
Governor's Office for Local Development	Southeastern Regional Agricultural and Exposition Center in Corbin	12,000,000	
Cabinet for Health and Family Services	General Administration and Program Support - Network Infrastructure Upgrade	782,000	
	General Administration and Program Support - Safeguarding Children at Risk (TWIST Re?Write)	2,205,000	
	Mental Health and Mental Retardation - Replace Roof – Oakwood	2,200,000	
Justice and Public Safety Cabinet	Corrections - Replace Electronic Offender Mgt. Systems Ph I	5,000,000	
Department of Military Affairs	Acquire Land for Wendell H. Ford Regional Training Center	4,250,000	[4,5]
Council on Postsecondary Education	Kentucky Community and Technical College System - Henderson CC Technology Center	13,066,000	
	Kentucky Community and Technical College System - Madisonville Technology Center	14,000,000	
	Kentucky Community Technical College System - Franklin Technology Center - Expansion	2,700,000	[5]
	Kentucky State University - Young Hall Renovation	5,339,000	
	Kentucky State University - Hathaway Hall Renovation – Phase II	7,400,000	
	Murray State University - New Science Complex	15,000,000	
	Northern Kentucky University - Regional Special Events Center	54,000,000	
	University of Louisville - HSC Research Campus Facility, Phase III	39,150,000	
	Western Kentucky University - Math and Science Academy Renovation	3,750,000	
	TOTAL	**$278,441,000**	

[1] Excludes allocable costs of issuance.
[2] Economic Development Bond Pool Reauthorization.
[3] Previously Agency Fund supported.
[4] Less than full Authorization.
[5] 2006 General Assembly Authorization.